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Avoiding Bad Faith Claims from Settlement Negotiations: Coverage Defenses & the Duty to Defend, Settle Claims

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Why This Topic Is Important

The Insurance Policy—the Foundation of the Insurance Relationship

- Insurance policies are contracts to which general contractual principles apply. *Bean v. Allstate Ins. Co.*, 403 A.2d 793 (Md. 1979)
- Insurers and policyholders are the contracting parties.

- An insurer has a duty to defend if the facts alleged in the underlying complaint fall within, or potentially within, the policy's coverage. *Illinois State Bar Association Mut. V. McNabola Law Group, P.C.*, 2019 IL App (1st) 182386, ¶ 13.

- An insurer's duty to defend is broader than its duty to indemnify. *Id.* See also *Crawford v. Weather Shield Mfg., Inc.*, 44 Cal. 4th 541, 547 (2008); *American and Foreign Ins. Co. v. Jerry's Sport Center, Inc.*, 606 Pa. 584, 608 (2010).

- Actual notice of a claim triggers an insurer's duty to defend. *American Service, Inc. Co. v. China Ocean Shipping Co.*, 402 Ill.App.3d 514 (1st Dist. 2020); tender of defense is not necessary in Illinois.

- What if only some third-party claims are covered?

If the underlying complaints allege several theories of recovery against the insured, the duty to defend arises even if only one such theory is within the potential coverage of the policy. *Maryland Casualty Co. v. Peppers,* 64 Ill.2d 187, 355 N.E.2d 24 (1976).

- Insurers' Options Once Duty to Defend is Triggered:
  - Accept the insured's defense without a reservation of rights;
  - Accept the defense pursuant to a reservation of rights and file a declaratory judgment action;
  - Refuse to defend the insured and file a declaratory judgment action.
- Insurer can also simply deny the defense and do nothing, but this comes with risk.

- Does defending under a reservation of rights trigger an insured's duty to settle a claim within policy limits? Different approaches in different jurisdictions:
  - "Fairly Debatable Test" used in many jurisdictions - where a carrier can reasonably examine a set of facts and determine that the incident or occurrence which is the substance of the underlying controversy is not one contemplated by the policy;
  - A delay in settling a claim does not create bad faith if the delay results from a *bona fide* dispute regarding coverage (Delaware; Illinois)

- Conversely, some jurisdictions hold "a good faith but mistaken belief that the policy does not provide coverage is not a defense to claims for bad faith failure to settle within the policy limits (*Eskridge v. Educator and Executive Insurers, Inc.*, 677 S.W.2d 887 (Kentucky))

- Insurers' Obligation to Inform Insured of Settlement Negotiations While Providing a Defense

  - Some states have held this obligation exist. "The covenant of good faith and fair dealing obligates an insurer to: 1) inform the insured of all settlement offers; and 2) to inform the insured of the possibility the injured claimant may recover a judgment in excess of the policy limits." *O.K. Lumber Co. v. Providence Washington Ins. Co.*, 759 P.2d 523, 525 (Alaska 1988). See also Arizona, Florida, Nevada, Wisconsin.

The Insurer's Duty to Its Policyholder To Settle Claims—General Principles

- Among the duties an insurer has under a liability policy is to make reasonable settlement decisions when a third party has made a demand against the insurer's policyholder.

Overview of the Liability Insurer's Duty To Settle

- An insurer's duty to settle a claim against its policyholder arises when:
  - The third party's claim is actually covered under the policy. *DeWitt v. Monterey Ins. Co.*, 204 Cal. App. 4th 233 (2012).
  - The third party claimant has made a reasonable settlement demand within the policy's limits of liability. *Johansen v. California State Auto. Ass'n Inter-Ins. Bureau,* 538 P.2d 744 (1975).
    - If the insurance company fails to investigate a potential settlement or fails to initiate settlement discussions. *See, e.g.*, *SRM, Inc. v. Great Am. Ins. Co.*, 798 F.3d 1322 (10th Cir. 2015).
    - There is a reasonable opportunity for the insurer to settle the claim. *Johansen v. California State Auto. Ass'n Inter-Ins. Bureau*, 538 P.2d 744 (1975).
      - Time component
      - Monetary component (*i.e.*, within policy limits)

Insurers' Obligation to Settle

"The assured is not in a position to exercise effective control over the lawsuit or to further his own interests by independent action, even when those interests appear in serious jeopardy. The assured may face the possibility of substantial loss which can be forestalled only by action of the carrier. Thus the assured may find himself and his goods in the position of a passenger on a voyage to an unknown destination on a vessel under the exclusive management of the crew."

- *Merritt v. Reserve Ins. Co.*, 34 Cal. App. 3d 858, 110 (1973).

- In general, an insurer has a duty to settle, on objectively reasonable terms, following a demand within its policy limits because the insurer has exclusive control over the settlement negotiations.

Insurers' Obligation to Settle (con't)

- The effect and necessity of a demand is specific to the jurisdiction
  - *Trout v. Nationwide Mut. Ins. Co.*, 316 Fed. Appx. 797 (10th Cir. 2009) (insurer acted unreasonably by failing to take advantage of the opportunity to settle for policy limits when it knew claimant's injuries far exceeded those limits, even if a "demand" had not been formally made.)
  - *Rova Farms Resort, Inc. v. Inv'rs Ins. Co.*, 65 N.J. 474 (1974) ("the insurer has an affirmative duty to explore settlement possibilities…At most, the absence of a formal request to settle within the policy is merely one factor to be considered in light of the surrounding circumstances, on the issue of good faith.")
  - *Delancy v. St. Paul Fire & Marine Ins. Co.*, 947 F.2d 1536 (11th Cir. 1991) (Georgia law does not clearly require the insured to show that the insurer refused an offer within the policy limits to establish liability for tortious failure to settle, but it does not foreclose the argument that such an offer is required before the insured may recover. At a minimum, however, Georgia law mandates that the insured show that settlement was possible -- the case could have been settled within the policy limits, and that the insurer knew, or reasonably should have known, of this fact.)

Insurers' Obligation to Settle (con't)

- *Haddick v. Valor Ins.*, 198 Ill.2d 409 (Ill. 2001) (insurers duty to settle arose when demand was made; insurer's offer to settle for policy limits nearly one year later, after demand was withdrawn, was a breach of duty to settle.)

- *Howard v. Am. Nat'l Fire Ins. Co.*, 187 Cal. App. 4th (2010) (in a single-insurer case, the opportunity to settle is shown by proof that the injured party made a reasonable settlement offer within the policy limits and the insurer rejected it. In a multi-insurer case, a demand within the policy limits of *all* available coverage constitutes an opportunity to settle.)

- *Am. Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842 (Texas 1994) (the *Stowers* duty to settle is not activated by a settlement demand unless three prerequisites are met: (1) the claim against the insured is within the scope of coverage, (2) the demand is within the policy limits, and (3) the terms of the demand are such that an ordinarily prudent insurer would accept it. A demand above policy limits does not trigger the duty to settle.)

Insureds' Participation: Voluntary Contributions

- Depending on the type of policy, indemnification for voluntary settlement payments made by an insured without permission or approval by the insurer are often excluded from coverage by policy language known as "no voluntary payment" clauses
- *Travelers Prop. Cas. Co. of Am. v. Stresscon Corp.,* 370 P.3d 140, 144 (Colo. 2016) ("no voluntary payments" clause clearly excluded from coverage any payments voluntarily made or obligations voluntarily assumed by the insured without consent, for anything other than first aid.)
- *Charter Oak Fire Ins. Co. v. Color Converting Indus. Co.,* 45 F.3d 1170, 1174 (7th Cir. 1995) (failure to enforce a "no voluntary payments" clause would constitute a windfall for insureds by judicially expanding coverage beyond the policy contract as written as well as potentially lead to collusion which ultimately results in higher risk for insurers and higher premiums for insureds.)

Insureds' Participation: Consent to Settle

- Depending on the specific policy language, an insurer may settle claims *against* its insured without the insured's consent. *Employers' Surplus Line Ins. Co. v. Baton Rouge*, 362 So. 2d 561 (La. 1978); *Bratton v. Speaks*, 286 S.W.2d 526, 527 (Ky. 1956) ("the standard liability insurance policy ordinarily gives the insurer the right to make such investigation, negotiation and adjustment of any claim or suit it deems necessary, and it is well-established the insurer may effect any compromise and release of the claim or suit of a third person it considers just and advantageous, provided in doing so it acts in good faith.")
- Some policies, particularly professional malpractice policies, contain "consent to settle" clauses which require an insurer to get the insured's permission before settling a claim against them.
- In the absence of such a provision, an insurer may conclude a settlement without the insured's permission. *See Teague v. St. Paul Fire & Marine Ins. Co.,* 10 So. 3d (La. App. 1 Cir 04/07/09).
- However, an insured's refusal to settle does not automatically end an insurer's good faith obligations. *Rawan v. Cont'l Cas. Co.,* 483 Mass. 654 (2019) ("The determination whether an insurer has complied with its dual obligations, despite the existence of a consent-to-settle clause, is a factual one to be measured in terms of the insurer's good faith efforts and transparency toward both its insured and a third-party claimant. These efforts would include a thorough investigation of the facts, a careful attempt to determine the value of a claim, good faith efforts to convince the insured to settle for such an amount, and the absence of misleading, improper, or "extortionate" conduct towards the third-party claimant."

Insureds' Participation: Recovery of Contributions by Insureds

- An insurer's breach of the duty to settle which forces an insured to contribute to a settlement gives rise to a claim for reimbursement of that contribution. *Isaacson v. Cal. Ins. Guarantee Ass'n*, 750 P.2d 297 (1988)
- Similarly an insurer's insistence that an insured contribute to a settlement within policy limits supports a contractual bad faith claim. *Rova Farms Resort, Inc. v. Inv'rs Ins. Co.*, 65 N.J. 474, 478, 323 A.2d 495, 497 (1974)
- However, an insured who, along with the insurer, voluntarily contributes to a settlement below policy limits in violation of a "no unauthorized settlement" exclusion cannot seek reimbursement of their contribution from the insurer. *McMahon v. Med. Protective Co.*, 92 F. Supp. 3d 367 (W.D. Pa. 2015) (the "no unauthorized settlement" clause of the policy unambiguously applied not only to settlements made solely by the insured but also to those where the insured offered to contribute funds above the amount offered by the insurer.)

Allocation – Who Pays What?

- Insurance matters frequently include both covered and uncovered claims as well as multiple insurers and /or reinsurers, so it's vital to be aware of the limitations of each party's obligations.
  - Loss allocation provisions
- Covered v. Uncovered Claims
  - Typically, an insurer has no obligation to settle claims for which the policy does not afford coverage. *Camelot by the Bay Condo. Owners' Ass'n v. Scottsdale Ins. Co.,* 27 Cal. App. 4th 33 (1994) (an insurer denies coverage at its own risk if and only if coverage is ultimately found.)
  - In the event that an insurer settles a matter including covered and uncovered claims, it is proper that that insurer seeks contribution for the amounts paid towards uncovered claims from the insured, provided that the insurer has reserved its rights to do so. If the insurer has not explicitly reserved this right, it waives the ability to recoup amounts paid towards uncovered claims. *Facility Invs., LP v. Homeland Ins. Co. of N.Y.,* 741 S.E.2d 228 (2013)
  - Some policies contemplate the necessity of retroactive application of judicially-determined allocations between covered and uncovered claims *Fed. Ins. Co. v. Hawaiian Elec. Indus.*, 1995 U.S. Dist. LEXIS 22594 (D. Haw. Dec. 14, 1995) (binding allocation between covered and uncovered claims (by jury, court, or arbitration) is typically only available after the time when claim-related costs must be incurred.)

Allocation – Who Pays What? (con't)

- Covered v. Uncovered Claims (con't)
  - Insurers/parties *may* contemporaneously allocate funds between covered and uncovered claims in settlement; however, this is not always the final word on allocation.
  - *UnitedHealth Grp., Inc. v. Columbia Cas. Co.*, 941 F. Supp. 2d 1029, 1034 (D. Minn. 2013) (even when the parties have allocated in writing at the time of settlement, Minnesota courts have allowed the insured to later argue for an allocation that differs from the settling parties' contemporaneous allocation.)

Obligations & Rights of Excess Insurers

- Excess insurers have obligation to participate in settlement negotiations in good faith with primary insurers, but they typically do not have to offer monies to settle before the primary coverage is exhausted.
  - *Associated Wholesale Grocers v. Americold Corp.*, 261 Kan. 806, 808, 934 P.2d 65, 70 (1997) ("An excess insurer owes an implied good faith obligation regarding settlement negotiations. Even if it has not assumed the defense or control of settlement negotiations, an excess insurer has the right under the policy to consent to any settlement reaching its coverage level. The excess insurer has an implied obligation to exercise that right in good faith.")
  - *SRM, Inc. v. Great Am. Ins. Co.*, 798 F.3d 1322, 1327 (10th Cir. 2015)(an excess insurer has a reasonable economic expectation that it will not be responsible on its policy until the primary insurance has been exhausted in accordance with the express provisions and obligations in the insurance contract, even if the claim against the insured is for a sum greater than the primary coverage.)
- However, when liability clearly exceeds underlying policy limits, all excess insurers in turn each became liable for the entirety of any excess amount, consistent with the terms of their policies. *Polygon Nw. Co. v. Am. Nat'l Fire Ins. Co.*, 143 Wash. App. 753, 774, 189 P.3d 777, 788 (2008)

Obligations & Rights of Excess Insurers (con't)

- Excess insurers share a duty of care among and between themselves, primary insurers, and insureds
  - *Transit Cas. Co. v. Spink Corp.*, 94 Cal. App. 3d 124 (1979) (an excess insurance carrier seeking recovery from the primary carrier for wrongful refusal to settle may recover on a theory of negligence based on a triangular reciprocal duty of care existing among the insured, the primary carrier and the excess carrier.)

- Excess insurers *may* participate in and conclude settlements without exhaustion of the primary policy
  - *Preferred Prof'l Ins. Co. v. Doctors Co.,* 2018 COA 49, ¶ 14, 419 P.3d 1020, 1023 ("From settled Colorado insurance law, we conclude that an excess carrier asserting an equitable subrogation claim against a primary carrier for failing to settle must plead and prove that the primary insurer's settlement decisions were made in bad faith.")

Consequences of an Insurer's Breach of Duty To Settle

- The insurance company acts at its own risk in not settling a covered claim. *Johansen v. California State Auto. Ass'n Inter-Ins. Bureau*, 538 P.2d 744 (1975).
- "...it is the affirmative act of the insurer in unreasonably refusing to pay a claim and failing to act in good faith, and not the condition of nonpayment, that forms the basis for liability in tort. An actual judgment in excess of the policy limits is therefore not a necessary prerequisite to a claim of bad faith breach of an insurance contract." *Farmers Grp., Inc. v. Trimble*, 691 P.2d 1138, 1142 (Colo. 1984).

- Depending on the jurisdiction, the insurer may be liable for all consequences of its wrongful rejection of a settlement and the limits of liability will no longer apply. *Nunn v. Mid-Century Ins. Co.*, 244 P.3d 116 (Colo. 2010) (entry of judgment in excess of policy limits against an insured was sufficient to establish damages for a bad faith breach of an insurance contract claim against its insurer); *Johansen v. California State Auto. Ass'n Inter-Ins. Bureau*, 538 P.2d 744 (1975); *Babcock & Wilcox Co. v. Am. Nuclear Insurers*, 131 A.3d 445, 457 (Pa. 2015); *Soto v. State Farm Ins. Co.*, 83 N.Y.2d 718 (1994).

Relationship Between Primary and Excess Insurers

- "The policyholder pays for two kinds of liability coverage, each at a different rate. The premium charged by the primary insurer supports more localized claims adjustment facilities than those of the excess carrier. It takes into account costs of defense, including legal fees, which the primary insurer normally provides. The excess carrier is less frequently confronted with loss possibilities…"
  - Diamond Heights Homeowners Ass'n v. Nat'l Am. Ins. Co., 227 Cal. App. 3d 563, 580, 277 Cal.Rptr. 906 (1991).

- If the insured purchases excess coverage, he in effect substitutes an excess insurer for himself. It follows that the excess insurer should assume the rights as well as the obligations of the insured in that position.
  - Continental Casualty Co. v. Reserve Ins. Co., 238 N.W.2d 862, 864 (Minn.1976).

Excess Insurer's Right to Settle Unilaterally

- Excess insurer has no independent right to veto a reasonable settlement decision made by the primary insurer
  - Diamond Heights Homeowners Ass'n v. Nat'l Am. Ins. Co., 227 Cal. App. 3d 563, 580, 277 Cal.Rptr. 906 (1991).
- Primary insurer that declines to engage in settlement negotiations when insured's liability is clear and damages would be far in excess of policy limits can be liable to excess insurer under California law for breach of duty of good faith and fair dealing
  - Continental Cas. Co. v. U. S. Fid. & Guar. Co., 516 F.Supp. 384 (N.D. Cal., 1981)

Duty of Good Faith Owed by Primary to Excess

- Under the doctrine of equitable subrogation, excess insurer may be subrogated to the position of the insured vis-a-vis the primary insurer's duty of good faith.
- Primary must consider in good faith the interests of the excess insurer equally with its own and must conduct the defense of the litigation, including settlement negotiations, so as not to expose the excess insurer to unwarranted liabilities.
  - Diamond Heights Homeowners Ass'n v. Nat'l Am. Ins. Co., 227 Cal. App. 3d 563, 580, 277 Cal.Rptr. 906 (1991).

Additional Considerations

- What if there are multiple claimants and some claims are covered, some are not?
  - Review the particular jurisdiction; some have "first in time, first in right" rules, others require "equitable distribution" of policy limits.
  - Does exhausting the policy limits by settling with some but not all claimants set up a bad faith claim?
    - Some jurisdictions require notice to the other claimants prior to settlement; others do not.

Additional Considerations

- What if there multiple insureds, some who are covered and some who may not be covered?
  - Check your jurisdiction to see if you need to apprise the potential non-covered insured of settlement negotiations on behalf of the covered insured?
- Can a third-party claimant bring a suit directly against the insurer for bad faith, or does there need to be an assignment by the insured and/or a verdict in excess of policy limits?

Additional Considerations

- Collaborative settlements between insured and claimant without insurer participation

Purpose of Reservation of Rights

- Permits insurer to provide an initial defense while reserving its right to later dispute coverage
  - Insurer usually has limited information at inception of case
    - Additional info may show claims are not covered
    - Insurer wants to avoid defense/indemnity for non-covered claims and preserve right to reimbursement of defense costs expended
  - Insured may need quick defense to respond to pleadings
- Notifies insured of potential coverage limits to make informed decision
  - E.g., scope of defense, covered and non-covered claims, potential exclusions to coverage, potential conditions

Scope of Reservation of Rights

- Coverage defenses – claim outside purview of insuring agreement or exclusion applies
- Policy defenses – basis for rescinding/voiding coverage or denial due to breach of condition
- Reimbursement of fees, costs and payments expended
- Request info from insured to further analyze defenses

Timing of Reservation of Rights

- Most states have rules about promptly responding to request for coverage (e.g., N.J.A.C. 11:2-17.7)
- While no specific time for ROR letter, it should be sent within a reasonable time
  - 4 months or less can be reasonable.
    - Fire Ins. Exch. v. Fox, 423 N.W.2d 325, 327 (Mich. App. 1988)
  - 10 months or more can be unreasonable.
    - Transamerica Ins. Group v. Chubb & Son, Inc., 554 P.2d 1080 (Ct. App. Wash. 1976)
- Focus is typically whether the untimely reservation is prejudicial to the insured
- May need to update ROR as new info becomes available

Drafting the ROR - Preparation

- Choice of Law
  - Which state's substantive law governs the provisions of the policy at issue
  - Certain provisions may be void under state public policy
- Policies (and coverage parts) at issue
  - Type of policy – occurrence based or claims made
  - Primary or excess policy
  - Different coverage parts in package policy
- Relevant pleadings
- Extent of tender
  - Multiple insureds requesting coverage (e.g., owner and company are sued)

Drafting the ROR - Generally

- "Fairly inform" insured of coverage position
- Some jurisdictions have no specific statutory or regulatory requirements
- Must be comprehensive – risk of waiver and estoppel in certain jurisdictions
  - Typically waiver and estoppel cannot be used to create insurance coverage when none exists
  - Exception to general rule is when insurer assumes defense without timely reserving its right to deny coverage.
    - See, e.g., Merchants Indem. Corp. v. Eggleston, 179 A.2d 505, 512 (N.J. 1962)

Drafting the ROR - Contents

- Introduction
- Factual background and procedural history
- Pertinent policy provisions
- Insurer's coverage position
- Requests for additional information

Impact of Coverage Issues on Defense - ROR

- Insured perspective:
  - Phrasing of discovery
    - Decision to develop evidence in underlying case that may relate to coverage issues
  - Summary judgment considerations
    - Decision to move (or not move) for summary judgment on potentially covered claims that would leave only uncovered claims remaining
  - Trial strategy
    - Jury instruction and jury interrogatories
    - Potential that verdict may have implications on coverage depending on how the verdict form is worded

Impact of Coverage Issues on Settlement - ROR

- Ability to settle when defended under ROR
  - Varies by State
    - In some states, insured must obtain insurer consent to settle when defended under ROR – e.g., Washington
    - In other states, insured has right to settle without insurer's consent if notice is provided - e.g., Arizona
- Impact of policy limits (or less) settlement demand on insurer
  - Insurer must decide to accept demand
  - Personal contribution by insured?
  - If rejected, insurer risks potential waiver of policy limits for excess judgment against insured
  - Potential bad faith/punitive damage exposure
    - Insured may have right to assignment of claim without insurer's consent upon rejection of policy limits demand

Covenant Judgments

- Enforceable in many states, including WA
- If an insurer acts in bad faith, an insured can recover from the insurer the amount of a judgment rendered against the insured, even if the judgment exceeds contractual policy limits
  - Besel v. Viking Ins. Co., 146 Wn.2d 730 (2002)
- Insured's right to enter into a "Morris agreement"
  - United Servs. Auto. Ass'n v. Morris, 154 Ariz. 113 (1987)
- The principles apply whenever an insurer acts in bad faith, whether by poorly defending a claim under a reservation of rights, refusing to defend a claim, or failing to properly investigate a claim
- Most Commonly Occur When Insurer Breached Duty to Defend or Duty to Settle

Covenant Judgments - Procedure

- Bad Faith by Insurer
- Agreement between Insured and Plff
  - Common Components
    - Settlement Amount
    - Assignment of Claims
    - Stipulated Judgment
    - Covenant to Not Execute on Judgment Against Insured
    - Cooperation of Insured
    - Hold Harmless of Insured

Covenant Judgments - Procedure

- Motion for Court Approval of Settlement
- Motion to Intervene by Insurer
- Motion for Reasonableness Hearing - RCW 4.22.060
- Chaussee Factors
  - Plaintiff's damages;
  - Merits of Plaintiff's liability theory;
  - Merits of Insured's defense theory;
  - Insured's relative faults;
  - Risks and expenses of continued litigation;
  - Insured's ability to pay;
  - Evidence of bad faith, collusion, or fraud;
  - Plaintiff's investigation/ preparation of the case; and
  - Interests of the parties not being released.

Covenant Judgments - Risk

- The Washington Supreme Court has repeatedly acknowledged the danger of collusive or fraudulent settlements in cases involving covenant judgments.
- "Because a covenant not to execute raises the specter of collusive or fraudulent settlements, the limitation on an insurer's liability for settlement amounts is all the more important. A carrier is liable only for reasonable settlements that are paid in good faith."
  - Bird v. Best Plumbing Grp., LLC, 175 Wn. 2d 756, 765-66 (2012); Besel v. Viking Ins. Co., 146 Wn. 2d 730, 738, (2002)

Summary

- Major points / takeaways.